The ECONOMIC *Background*

THE INTERNATIONAL ENVIRONMENT

Overview

The world economy continues to be in a state of flux after the recent financial crises. The NAFTA economies are performing well with strong growth (up 4% last year) and low inflation but the slowdown in Euro Area persists while the Japanese economy remains in recession. The latter is forecast to see output decline by 1.5% this year having already shown a fall of 3% in 1998. Growth is expected to slow considerably in Latin America while there is virtually no institution that is optimistic about the situation in Russia. There are signs of recovery in the Asian economies however and this is encouraging news. The continued fall in commodity prices and falling producer prices has kept inflation subdued on a global basis. The oil price has risen slightly recently but is not likely to contribute to inflation significantly. A positive sign for the world economy is the strengthening of long term interest rates suggesting that the future may be better than expected. Global trade looks set to rise steadily but slowly. The depreciation of the Euro since the beginning of the year has made the Euro economies slightly more competitive and is a cause for some concern. Conversely the dollar has appreciated as has the non-Euro currencies in the EU. The outlook for the global economy is relatively promising. Our forecasts for the major economies are given in Table 1.

The USA

The US economy is still in good health with strong growth, high capacity utilisation, and an increasing rate of growth of total factor productivity and declining inflation. Inflation is at its lowest since 1955 and unemployment is at its lowest since 1970. US equities have appreciated significantly and the monetary policy response to the fears over financial contagion has been sound. Consumer expenditure grew by 1.5% in 1999q1 with forecasters expecting around 3.5% GDP growth for 1999. Housing starts are high but industrial production only grew by 0.25% in the first quarter while capacity utilisation fell by 1%. The industrial and service sectors exhibit this divergence probably because demand and production in the non-traded sector remains strong but in the traded sector external competition (mainly from Asia) continues to have an adverse effect.

Short term interest rates may rise soon in the US because of the rise in the oil price and this could restrict growth by a few percentage points this year but more importantly broad money (M3) has grown by just over 10% in 1999q1. This could add up to 0.5% to inflation in the year 2000. Consumption grew by 5% in 1998 while real disposable incomes grew by 3.1%. Consumer confidence has shown a complete recovery since last autumn. Civilian employment grew by 0.7% in 1999q1 with growth of 1.5% in 1998 as a whole. The claimant unemployment rate in March was 4.2% while average earnings grew by 0.9% in the first quarter of this year after rising by 0.8% in 1998q4. Labour productivity grew by 2.25% last year.

The outlook for the US is reasonably good. We expect GDP growth of 3.5% this year but declining to 1.9% in the following year. There are signs that inflation will rise this year. The current account has weakened slightly and this may continue, as fixed investment is greater than the rise in national savings. We also expect some further appreciation of the US dollar.

Europe

GDP growth is expected to slow to 2.1% this year in the Euro Area after growth of 2.9% last year. Last year only Italy and the UK did not match the growth of the Euro Area (circa 2.7% in 1998). The EU as whole is expected to have growth below 2% for 1999. Weak external demand and an appreciation of the Euro currencies against the dollar in 1998 hindered exports and thus growth. It is likely that net exports in Europe will decline further this year despite the recent depreciation of the real effective exchange rate. The engine of growth in Europe will be internal demand. The depression of economic activity will further depress manufacturing output.

Inflation has been as expected very low throughout the Euro area. Falling commodity prices and the lack of capacity constraints have been the main factors here. Further deregulation will add to competition thus pushing prices down further still. Because of the Stability and Growth Pact however a tight rein is being kept on budget deficits to keep them below 3%. For 1998 the combined fiscal deficit relative to GDP is forecast to be 2.3% in 1998 and this will probably fall to 1.9% in 1999. It should be noted that the four countries outwith the monetary arrangements are also keeping a fairly tight monetary stance. Fiscal surpluses are expected in Denmark, Finland, Ireland and Sweden this year. Government expenditure declined sharply in the second half of 1998 despite an increase in the first half of 1998.

International Forecasts of Main Economic Indicators; 1999-2001[1]

	GDP (% change)			Short Term Interest Rates (%)		
	1999	2000	2001	1999	2000	2001
US	3.4	2.0	1.8	5.0	5.3	5.3
Japan	-1.4	0.4	1.1	0.7	0.6	0.7
Germany	1.6	2.8	2.6	2.7	2.8	3.0
OECD[2]	1.7	2.3	2.2	-	-	-
Euro Area	2.1	2.8	2.6	2.7	2.8	3.1
EU	2.0	2.1	2.2	-	-	-
	Inflation (% change)			**Unemployment Rate (%)**		
	1999	2000	2001	1999	2000	2001
US	1.4	2.3	2.3	4.2	4.5	4.7
Japan	-0.9	0.1	1.0	4.4	5.1	5.5
Germany	1.1	0.9	1.4	10.3	10.0	9.4
OECD[2]	1.1	1.6	2.0	7.3	7.3	-
Euro Area	1.0	1.4	1.8	10.3	10.0	9.4
EU	1.3	1.6	2.0	10.3	10.0	9.5

Data Sources;

[1] Fraser of Allander Institute, Bank of England Quarterly Economic Bulletin, Barclays Economic Review, Financial Times, IMF World Economy, National Institute Economic Review, OECD Economic Outlook, and various others.

[2] Economic Outlook, (1998), 64, December, OECD, Paris (with revisions).

Unemployment in the EU declined by 0.7% in 1998 and employment increased by 1.5%. This masks the fact that unemployment levels are above their equilibrium levels in most European countries and unemployment remains high on the policy agenda. Unemployment in the Euro Area is about 0.75% higher than in the EU as a whole but it is expected to fall by about 0.6% this year and by 0.3% next year.

German GDP growth was 2.8% last year but activity slowed during 1998, particularly export growth and industrial production also fell by a similar amount. German growth is forecast to be 1.6% in 1999 and 2.7% in the following year. Unemployment fell to 11% in 1998 and total employment increased by 0.5%. Recently the unemployment rate fell below 4 million for the first time in six years. In France GDP growth grew by 3.2% but is forecast to be just over 2% in 1999 and around 2.5% in the year 2000. Inflation is at its lowest for 40 years and unemployment fell from 12.6% in 1997 to 11.4% at the beginning of 1999. Total employment has risen by 0.4% from mid 1997 to mid 1998.

The European Central Bank's cut in interest rates of 0.5% should see output increase by a further 0.3% over 1999. The continued weakness of the Euro has helped growth as has the signs of recovery in Asia. The depreciation of the Euro will chiefly benefit Germany and France as trade with non-Euro economies comprises 15% of GDP for both these economies.

Japan and Asia

The situation in Japan remains grave with a fall in nominal GDP implying that there will be a further decrease in GDP growth this year. The good news is that there are some signs that the government's fiscal packages may be beginning to have some effect on the economy. The economy appears to be stabilising and while external and domestic demand remain weak; it may be that output will fall a further 1.5% or so. The government's November fiscal package amounted to Y23.9M. This time there was money allocated to credit relief, tax cuts, housing, training and employment and to other Asian economies. Reform of the financial sector is still a major issue.

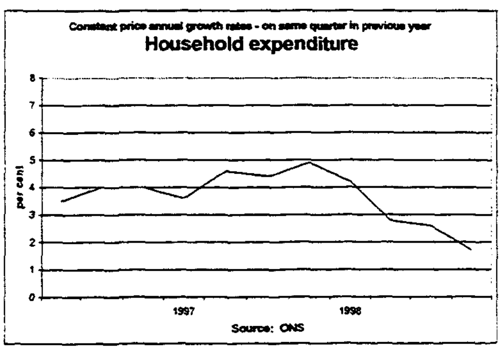
There is expected to be a further fall in inflation in 1999, possibly a whole percentage point. Wholesale prices fell by 1.3% in 1999q1, 4% down than a year ago. The slight appreciation in the Yen has seen import prices down by around 12%. Business confidence appears to be returning with the March Tankan survey reporting a modest upturn in business sentiment in both manufacturing and the non-manufacturing sectors. Equity prices have risen significantly primarily due to the banking sector. The unemployment rate was 4.6% in February which is a new post war record. Total employment in the three months to February was unchanged. Many firms have now taken considerable steps to reduce costs by reducing wages and hours worked. The fall in employment is likely to have a significant effect on incomes. The stagnation of personal incomes has been reflected in expenditures, personal expenditures declined by

0.8% last year and consumer confidence remains subdued.

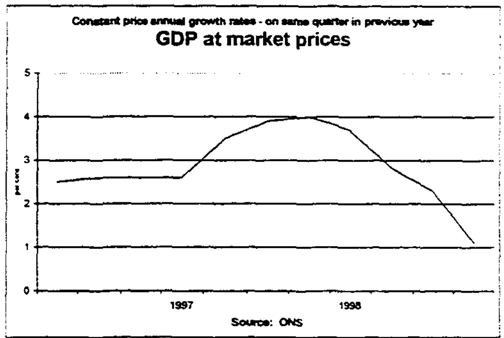
External demand was weak last year and this will probably be the case this year also. Exports raised GDP by 0.7% last year but as the export weakness was primarily due to the Asian crisis then an improvement here would be of considerable help. The outlook is for GDP growth of -1.4% and 0.8% in 1999 and 2000 respectively coupled to export growth that is constrained by the appreciation in the Yen. In the labour market unemployment is forecast to rise to 4.6% in 1999 and to 5.2% in the following year.

UK MACROECONOMIC TRENDS

In the fourth quarter of 1998, the estimate of **GDP at market prices** - 'money' GDP - rose by 0.5%. After allowing for inflation, **GDP at constant 1995 market prices** grew by 0.1% during the quarter, compared with 0.3% in the third quarter, 0.3% in the second quarter, 0.4% in the first quarter, and 0.8% in the fourth quarter of 1997. Over the year to the fourth quarter, **'real' GDP at constant market prices** is estimated to have risen by 1.1%. For 1998 as a whole, GDP growth is estimated to be 2.1%. Preliminary estimates of 'real' GDP growth for the first quarter 1999 suggest that the economy grew by 0.1% to a level 0.7% above the same period a year ago.



Output of the production industries in the fourth quarter *fell* by 0.9% to a level 0.5% higher than the same period a year ago. Within production: **manufacturing** experienced an decrease in output of 1.3% in the fourth quarter, output of the **other energy and water** supply industries rose by 1.5% in the fourth quarter, and **mining & quarrying, including oil & gas extraction** rose by 0.4%. Manufacturing output in the fourth quarter was 0.5% *below* the same period a year ago. The output of the **service sector** rose by 0.5% in the fourth quarter. Over the year to the fourth quarter service sector output rose by 2.7%. The **construction industry** experienced an increase in output in the fourth quarter of 0.1% with output in the industry falling by 0.8% over the year.

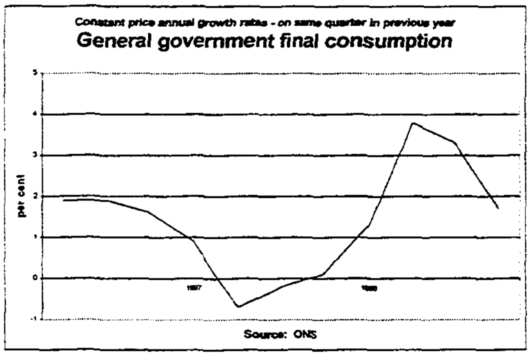


Preliminary estimates for the first quarter 1999 indicate that service sector out grew by 0.4% to a level 2.3% higher than in the first quarter of 1998.

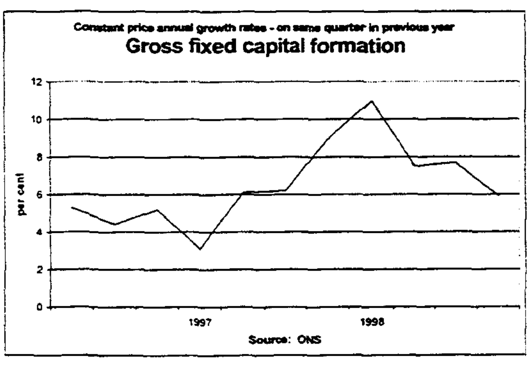
In the fourth quarter of 1998, **real households' expenditure** (which is consumers' expenditure *minus* expenditure by non-profit making institutions serving households) rose by 0.6%. This compares with a 0.1% rise in the third quarter, a 0.5% rise in the second quarter, a 0.6% rise in the first quarter, and a 1.3% rise in the fourth quarter of 1997. Spending during the fourth quarter rose by 1.7% on the same period a year earlier. In the fourth quarter, consumers' expenditure again failed to provide the main contribution to GDP growth. The contribution of consumers' expenditure to the GDP growth rate of 0.06% was 0.36% compared to a contribution of 0.53% from investment. The official seasonally adjusted estimate of **retail sales** volume for the three months to February indicate an increase of 0.2% over the preceding three months and a rise of 1% over the same period a year earlier. The amount of outstanding **consumer credit** rose by £0.94bn in February. This compares with an increase of £1.30bn in January and £0.59bn in December. The **household saving ratio** rose to 7.4% in the fourth quarter of 1998, from 6.3% in the third quarter, 7.3% in the second quarter, and 7% in the first quarter. The reported underlying increase in **average weekly earnings** in the year to February 1999 was provisionally estimated to have been 5%, which represents an increase of 0.4% points from the January rate. In February, private sector earnings grew by 5.1% over the year, while earnings in the public sector grew by 4.4%. **Real household disposable income (RHDI)** rose by

2.2% in the fourth quarter of 1998 to a level 0.6% higher than in the same quarter in 1997. The rise in the saving ratio in the fourth quarter reflects the slower growth of households' expenditure compared to the change in RHDI.

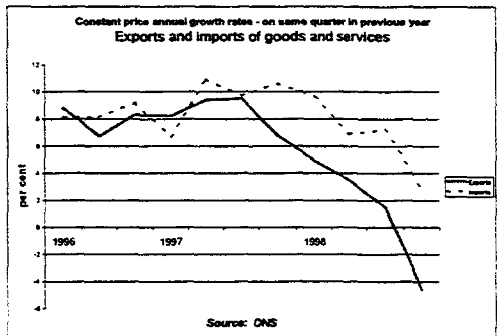
General government final consumption, rose by 0.3% in the fourth quarter, compared to an increase of 0.6% in the third quarter, 0.4% in the second quarter, and 0.4% in the first quarter. Government consumption in the fourth quarter was 1.7% higher than in the corresponding quarter of 1997. Government consumption made a contribution of 0.05% points to overall GDP growth of 0.06% in the fourth quarter.



Real gross fixed investment or Gross fixed capital formation rose by 2.9% in the fourth quarter to a level 7.2% higher than in the fourth quarter of 1997. This compares with growth of 2.9% in the third quarter and a broadly similar contribution to GDP growth.



Turning now to the **balance of payments**, the **current account** for the fourth quarter 1998 registered, after seasonal adjustment, a surplus of £0.95bn. This follows a surplus of £2.40bn in the third quarter and deficits of £1.2bn and £0.68bn in the second and first quarters respectively. For **trade in goods and services**, the *deficit* deteriorated to £3.37bn in the fourth quarter, after deficits of £1.81bn in the third quarter, £1.62bn in the second quarter and £1.13bn in the first quarter. The deficit in traded goods increased to £6.29bn in the fourth quarter, from £5.27bn in the third quarter, £4.79bn in the second quarter and £4.25bn in the first quarter. For **income and current transfers**, there was a surplus of £4.32bn in the fourth quarter, following surpluses of £4.23bn in the third quarter, £0.42bn in the second quarter and £0.45bn in the first quarter. The deterioration in the trade balance meant that net exports made a significant negative contribution to growth in the fourth quarter reducing GDP growth by 0.93% points.



UK LABOUR MARKET

Employment and Unemployment

Seasonally-adjusted UK claimant unemployment fell by 16,000 in the quarter to January and by 71,900 over the full year. UK claimant unemployment has been declining almost continuously since February 1994 and now stands at 1,290,700 giving an overall unemployment rate of 4.5%, with a male and female rate of 6.2% and 2.3% respectively. On the ILO definition, unemployment is slightly higher. For the quarter to March, it stood at 1,822,000, with an associated rate of 6.2%. On this definition there has actually been a small increase in the number of unemployed over the last quarter of 23,000, though a reduction over the full year of 32,000. The UK unemployment rate remains below the EU average rate, which is 9.6%. The persistent increase in total employment which has been in evidence for more than two years now continues. Total employment in the quarter from January to March numbered 27,351,000 and this represents an employment rate of 74.0%. This was an increase of 62,000 (0.2%) on the previous quarter and 327,000 (1.2%) on the previous year. However, the employment experience in the various sectors of the UK economy varied markedly. Over the quarter to December 1998, the biggest absolute increase in employment has occurred in banking, finance and insurance, with a rise of 51,000. The largest proportionate change is in transport and communications, where the increase is 1.8%. Agriculture and fishing and manufacturing continue to be sectors suffering employment reductions. The fall in manufacturing employment totalled 54,000 over the quarter and 99,000 over the year. Again, the proportionate change in agriculture for the quarter is 3.2% and 11.8% over the full year. Moreover, the more up-to-date figures for manufacturing give employment in March 3.2% lower than the figure for 12 months earlier. Whilst the total employment and unemployment figures change in a rather consistent manner, the level of vacancies notified at Jobcentres has fluctuated. The notified vacancy figure fell in February and March but increased in April to a level 4.9% higher than the corresponding figure for April 1998.

Earnings and Productivity

The GB headline (3 months average) annual increase in whole-economy earnings stood at 4.8% in March 1999. This figure peaked in June 1998 when it reached a level of 5.7%, subsequently fell to 4.5% in January 1999 and is now beginning to rise again. There is significant variation in wage increases between sectors. The headline figure in the private sector, at 5% still remains above the figure for the public sector, which is 4.1%. Again, the headline rate of increase in earnings to March in production industries is 3.5% whilst in service industries it is 5.0%. The annual rate of growth of labour productivity in the whole economy in the fourth quarter of 1998 was low at 0.7% and the change in the quarter was actually negative. Whole-economy productivity in the 4th quarter of 1998 was 0.2% lower than it had been in the 3rd quarter. In the recent past manufacturing productivity growth has been disappointing but the figures to March show a marked improvement with productivity 2.2% higher than the corresponding figure for the previous year. Given the productivity and wage change figures, we observe an annual increase in the whole-economy unit labour costs to the last quarter of 1998 of 4.2% and an increase in manufacturing to March 1999 of 2.2%.

UK OUTLOOK

GDP growth was almost stagnant in the fourth quarter of 1998 and the first quarter of this year. However, this was considerably better than the expectations of many commentators earlier in 1998 and appears to indicate that the risk of recession has largely receded. The dual economy persists nonetheless, with manufacturing experiencing a contraction for three successive quarters while the service sector is growing at an annual rate of about 2% per quarter.

During 1998, the growth of domestic demand weakened in the first quarter of the year (from 1.57% in Q4, 1997 to 0.76%), weakened further in the second quarter (0.49%), stabilised in third quarter (0.48%) and then grew more quickly in the final quarter of the year (0.96%). The slowdown in domestic demand in large part reflected the weakening of consumer demand as the effect of the windfall gains in 1997 began to unwind, but this was partly offset by a strong contribution from the growth of fixed investment in the third and fourth quarters. Net trade, on the other hand, has consistently made a negative contribution to growth for the past two years. However, from the fourth quarter of 1997 the negative contribution to growth of the external sector became more intense as the growth of imports accelerated, leading to a worsening trade deficit. The strong growth of imports and the stagnation of export demand are a reflection of the appreciation of sterling and the loss of price competitiveness by domestic British goods.

The growth of world trade is set to slow again in 1999, which, coupled with the poor competitive position of the British traded goods sector, is likely to result in a further deterioration of the trade balance. However, the deterioration is not expected to be as great as during 1998, as sterling depreciates slightly from the second quarter after the recent cut in base rate to 5% and as the growth of imports slows. This is likely to produce the result that the negative effect of net trade on growth should diminish but will remain substantial, with the attendant effect that the manufacturing sector is unlikely to display positive growth this year. The growth of domestic demand, on the other hand, is expected to continue to pick up during 1999. Surveys reveal that confidence is beginning to return to both the household and the corporate sectors, a reflection of earlier cuts in base rates and the realisation that the problems that affected emerging markets in 1998 have not been so damaging to the world economy as originally anticipated. In addition, government consumption should make a positive contribution to growth reflecting the slight loosening of fiscal policy in the Budget.

Overall, GDP growth should be at least 1% this year, and may be higher. The National Institute for Economic and Social Research is currently forecasting growth of 1.25% this year having revised upwards their earlier forecast of 1%. Inflationary pressures remain largely absent. Employment should continue to grow slowly, as productivity growth remains weak, while unemployment remains stable. Nevertheless, considerable uncertainties remain, particularly the risk of a downturn in the US economy, but a recession in the UK economy overall seems certain to be avoided.